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DEVELOPMENT BARRIERS OF PE/VC SECTOR IN POLAND

Introduction

In the following article the authors comprised their remarks and conclusions flowing out from the observation of the market and their own research concerning Private Equity/Venture Capital funds. Further more it has been tried to determine the most important barriers slowing the dynamics of this sector in Poland and assembling a model of the environment that is favorable to the further development. This is especially true for small and medium size ventures including entrepreneurs. The global expansion of the capital market has deployed a large access to the capital to start innovative projects. In Poland there are plenty of ideas to realize the commercial projects. The question is posed as to what is ratio between the massive of the capital versus number of viable projects? Do the ventures that implement the innovative projects have access to the capital? Do the VC funds have their own developed strategy tailored to the market conditions and project requirements? And how they are willing to take risk and park their capital in these undertakings? These aforementioned questions are being analyzed by the authors.

Argument
Based on the source papers, literature and informal interviews in the PE/VC environment we have formulated the hypothesis that the major barrier of growth in the PE/VC sector is absent of the governmental programs and public institutions that are the middle men between the creators of innovations and the capital providers.

Methodology
Methodology for identifying significant barriers to the development of the sector PE/VC has been based on the following sources of information:
– market observation,
– collected materials and the articles published in the literature and on the official web page of PSIK (Polish Investors Capital Association),

– informal interviews with the selected bodies associated and collaborated with private equity/venture capital segment.

Goals

1. Review of the sector of PE/VC funds in Poland, given indication of their implemented projects/completed projects.

2. Show relevant factors supporting or restricting the development of PE/VC in Poland.

3. Making revisions and updates to the environment model, enhancing the development of PE/VC in Poland.

Overview of the Market

Given the current property crisis in America, the sharp fall of the biggest stock exchange indexes and liquidity issues in central banks, one would assume that this general pessimism would prevent capital inflow into Poland. In fact, it is quite the contrary – private equity market has witnessed a dramatic upturn. Investors are very much interested in investing in Polish private assets. Increased money supply and the consequent favorable appraisals are of much interest to entrepreneurs looking to finance their businesses through private equity. However, a closer look at the situation shows that the main share of venture capital is allocated to the start-up or seed small and medium-size companies (MSP sector). The capital invested does not usually exceed EUR 1,000,000. In comparison with the situation on private equity/venture capital market a few years ago, the popularity of this sector in Poland has significantly grown. Many entrepreneurs can now choose from such funds as: Mid Europa Partners (MEP), started in autumn 2007, with USD 1.5 billion for investments in Central Europe, Enterprise Investors, Advent, Innova Capital, MCI. Another two funds that started their activity in Poland in 2007 were Bridgepoint and Carlyle Group. It follows that investing in Polish private assets is of huge interest for investors as the year 2007 has proved. Profitable appraisals, which followed the increased money supply, induce more and more entrepreneurs to finance their businesses from private equity/venture capital funds. To quote some of the data, the biggest transaction of the last year, which amounted to EUR 300 million or PLN 1 billion, was the sale of 75 per cent of shares of the rail operator, CTL Logistics, to Bridgepoint carried out by Jaroslaw Pawluk. Another of the major transactions was the purchase of grocery stores chain ‘Zabka’ by a Czech fund Penta Investments at the price of EUR 80,000 for each store.

As already mentioned, private equity/venture capital funds are primarily interested in smaller companies from fragmented markets where consolidation, among other things, offers better growth opportunities. An example of such activity in the past year is the takeover of payment card transactions processor, Polcard, by KKR (Kohlberg Kravis Roberts) through First Data. The transaction amounted to EUR 238 million. Furthermore, Permira took over fodder producer, Rolimpex, thorugh

Provimi, Mid Europa Partners – Lux-Med, and Supernova Capital – Scanmed. It can be seen that most funds, which invest in Poland, are foreign and their capital is significantly higher then the one of the Polish private equity/venture capital funds. The capital involved amounts up to 15 times the capital of the Polish funds and, most importantly, their scope of activity is greater. Polish funds show some activity, too, although their activity scope is the niche of small and medium-size companies sector (MSP). The examples are acquiring a share of a publishing company, PPWK, by Supernova via NFI Progress, or kitchenware producer, Emalia Olkusz, restaurant chain Hard Rock Café, acquiring a share of cash registers producer, Elzab, by BBI Capital or a share of construction company Awbud.

At present, funds usually obtain their capital in three ways. These are: exiting from the previous investments, leveraged buyouts offered by financial institutions and money on the capital market coming from the sales of shares or investment certificates. Foreign funds often get the capital from institutional investors. Polish funds usually use financing from the stock exchange, although it is a relatively expensive method. This is normally done via the sale of minority interest allowing a quick market entry. The money acquired from transactions with the funds is usually used to pay off the shareholders or for the further development of the company.

It seems that, as the funds enter more and more new areas of activity, private equity/venture capital investments in Poland will develop further.

Assessment of mutual fund vis-a-vie company relationships

According to the findings presented in the exploratory research entitled "Understanding the barriers to and opportunities for access to private equity among small-to-medium-sized family-owned enterprise (SMFE) owners in Australia, an exploratory study" done by Pin-Shen Seet, Christopher Graves, Magdalena Hadji, Andrew Schnackenberg and Petter Gustafson from University of Adelaide, it has been identified that the three major areas that reflect barriers to populate and engaging PE/VC to boost and expand growing businesses are: Finance Gap, Knowledge Gap, and Empathy Gap.

We have taken their findings and applied to our PE/VC capital business context and we have tried to model this with our findings and observations and thereby we have grouped them in similar way as: (1) knowledge/experience gap, (2) capital/finance gap and the (3) empathy gap.

The first stage of observations focused on the assessment of the knowledge of the terms of private equity/venture capital funds in the small and medium-size companies sector, mainly in the companies which do not use such sources of financing. It turned out that pe/vc funds are not yet well-known in Poland. A fraction of entrepreneurs confirms that they have heard of the funds and the opportunities which can be gained in this way. However, most of them have never tried to secure financing from such funds. This includes any experience or knowledge about vehicles applied in securing financing, the investment criteria generally recognized and used by PE/VC funds. It can be seen that Polish companies show little interest in cooperation with PE/VC funds. Clearly, a need is arising to popularize the term among the large number of companies active on the Polish market. Another, more significant problem, could be spotted based on source materials. Many companies, which do not use PE/VC financing, indicated that they have serious difficulties in acquiring it. What is the reason for this state of affairs? What barrier prevents cooperation of funds and numerous companies? Further in this paper we will try to answer these questions. We have witnessed that many small owners and entrepreneurs are hesitant to discuss financing with outsiders and they are no sophisticated to seek outside help and advice.

The next stage of observations was devoted to the assessment of finance gap as well as the cooperation between the PE/VC funds and the companies from their portfolio as seen from the entrepreneur's perspective. Today medium and small size companies are challenged by the size of the minimum investment criteria and the corresponding size of the small or medium size company that is searching for PE/VC funding. The above gaps are even larger among the entrepreneurs and business and family owners. The lack of finance sources may be exemplified by the professional advisors as accountants and tax advisors lack the experience to use the PE/VC.

Private equity/venture capital funds turned out to be of great importance for the companies investigated. According to the managers, the funds influence enormously the increase in the value of their companies. Advantages mentioned included the implementation of know how, full professionalism, full ongoing control, professional management of the company finances and carrying out the project, fast-paced positive changes, management and legal support, professional and quick decision-making as well as experienced staff. Financing companies from private equity/venture capital funds turns out to be highly satisfactory for both parties, which indicates the importance of companies-funds cooperation and financing Polish companies from such capital.

Another sensitive area was an empathy gap. In our view it concerns between the owners and "receivers" of the capital and their personal reasons and future short and long term goals.

Small and medium size companies as well as individual business people/entrepreneurs have been contrasting with PE/VC due to the absence of any experience. Furthermore, it often noticeable that for most entrepreneurs and the owners' preference of the title, control and the job security is more important than ROI. However, small owners and entrepreneurs like to look at the long horizon. The nature of PE/VC business is to bank opportunities and projects that will yield high or extraordinary returns.

Another stage of observations was devoted to the assessment of the cooperation between the PE/VC funds and the attempt to individuate the most important elements striking in favor or against the development of the PE/VC sector in Poland. Most frequently the political instability is being considered as the disadvantage following lack of capital concentration, lack of clarity in the regulations, antiquated tax schemes, long and convoluted legal and administrative procedures. Furthermore, capital market is still shadow and underdeveloped and yet offers limited ways of disinvestments.

On the other hand, as far as the advantages, we can include steady as expected growth of GDP, controlled inflation, PLN strength against Euro and foreign currencies.

Table 1. The variables that favor and limit the growth of the sector of PE/VC in Poland

VARIABLES	POSITIVE (*)	NEGATIVE(**)
The level of knowledge of PE/VC		–
Political stability		–
Economic state of Polish economy	+	
Functions of the capital market		–
Currency stability of the Polish currency	+	
Level of innovations of Polish economy		–
Tax system and regulations		–
Investment incentives and enhancements		–
Stability of the micro and macro.	+	
Access to the capital		–
Credentials and access to the Polish experts and experience managers	+	
Costs of the business practice	+	–
Inflationary index	+	
Exit options		–
Competition	+	–
Legal framework and commercial regulations		–
Investment risk		–
R&D Programs		–
Infrastructure and communications		–

* Positives – indicate positive variable that stimulate functionality and growth of PE/VC sector in Poland in 2007.

** Negative – indicates variables that institute a barrier for functionality and growth of PE/VC sector in Poland in 2007.

Source: own study and research.

PE/VC funds have been perceived to be usually highly sophisticated and usually controlled by very knowledgeable and well informed investors.

The fact that more and more PE/VC capital groups are already in Poland and in Central Europe enable them to have a better handle on developing and managing their portfolio. Close proximity locally to their project(s) and the management members who are running the projects help to maintain a close relationship and impose corporate governance and control performance of the overall investment.

There are over 200 billion of dollars of the PE/VC funds in the United States today and about 60 billion of dollars is available in Europe in PE/VC funds. As we can still see in Poland there is a noticeable gap to access the capital in the micro scale. The investors usually transfer and bank their capital to the large projects at the expansion or development stage rather than focus on early capital or start-up phase.

Private sector and the government should look at the ways to enhance the abilities for the small and medium size companies to attract more "fresh" money. Lack of sufficient transfer of new technologies reflects the abilities of medium and small developed companies to be more innovative and perform R&D programs to increase their productivity and sales and distribution output level and consequently be less competitive in their local and international markets.

We see a great demand and need for making PE/VC sector more proactive to undertake private and semi-government-private sponsored projects which will stimulate innovation and orders for new technologies and know-how. We foresee a pent-up demand for developing "seed" and "start-up" platforms to enable a development of innovative and pioneer projects.

We already see in Poland valid examples that majority of PE/VC implementations and ejections in the projects have been followed by a very detail and comprehensive due diligence where the investment process required drafting up strategy to roll out the business plan and establishing the operational priorities to execute the proposed investments.

The PE/VC ventures always look to build their investment and portfolio on real transparency between the PE/VC Fund and acquired owner(s) and the managing managers.

The PE/VC Funds while making investments or M&A should always keep in mind a Total Shareholders Return and to build a real value at the time of exiting the project rather than focusing at first on cutting costs of all the overheads. Boston Consulting Group have performed an analysis which compares the market value at the time of the purchase with value realized upon exit for a selected simple PE investment. Their findings have shown that 50% of the value created was attributable to growth and only 18.0% of the increase in value was attributable to cost and overhead cutting, further 37% of the value creation was attributable to valuation multiplies because of the improved value prospects at the time of the exit.

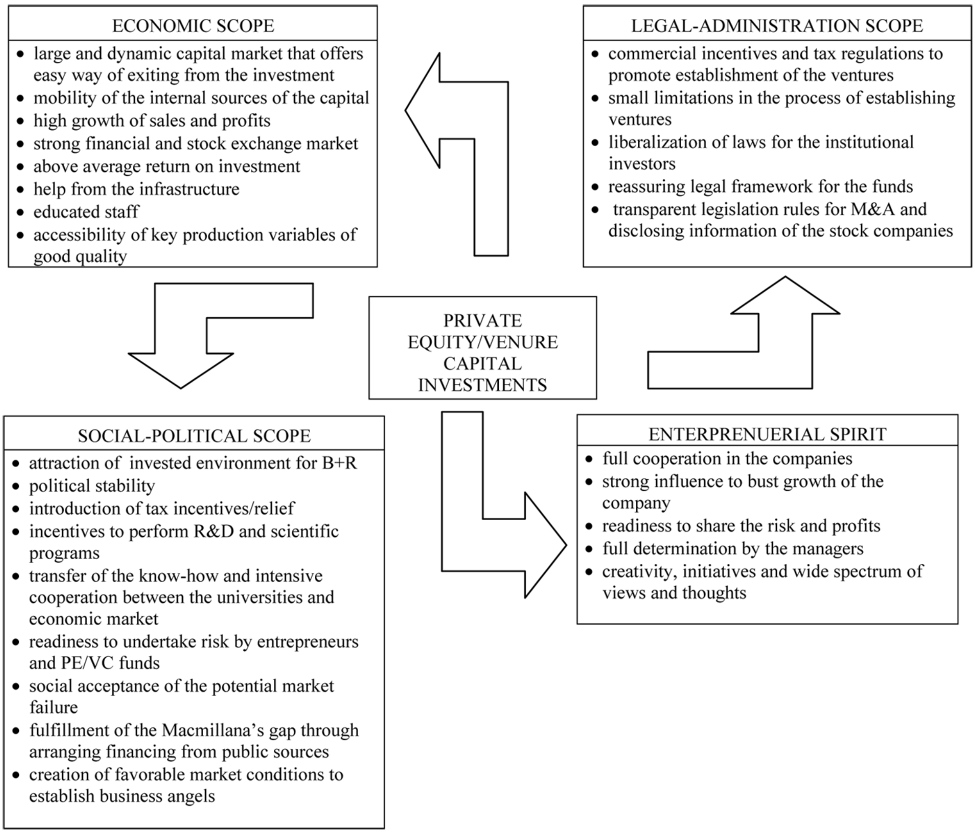

Fig. 1. Model of the environmental impacts to facilitate the functions of PE/VC in accordance with the model of P. Schofer and P. Leitinger

Source: own analysis based on [Schofer, Leitinger 2002, s. 10].

Conclusion

In our view there are strong indications that (1) knowledge/experience gap, (2) capital/finance gap and the (3) empathy gap contribute to slow down the growth of PE/VC in Poland. Moreover, lack of government programs, including expansion and growth of capital market with political, legal, administration reflects obstacles and gaps that influence in the unfavorably way the market of PE/VC is expanding and growing Poland. This picture of micro and macro-economy is reflecting relatively a small basket of large transactions and limited number of medium and small size start-up companies including start-up and companies spin off's and spin-outs. Looking from the retrospect of almost 19 years after the establishment of Polish-American Enterprise Fund the PE/VC sector is growing steadily in Poland but number of PE/VC investors is still quite limited. We currently can observe that the market of PE/VC is stimulated by the majority of large and medium size transactions. There are large deals and projects including M&A, MBO and many interesting IPO's. e.g acquisition of CTL Logistics (private rail operator) or acquisition of Lux-Med and Medycyna Rodzinna. Still small projects and start-up are not popular in Poland due to lack of incentive programs from the government and private sector and therefore they are being perceived as risky and with no enhancement.

Poland is considered to be one of the most important area for global growth and development and after accessing the EU, we have witnessed the dramatic changes in the way that the project financing takes place in the capital markets of transitional economies. FDI and good level of GDP will continue to have a huge impact on further development of PE/VC in Poland taking into account current 0.12% of Polish GDP (ave. 0.55% in EU).

We further foresee that there will be arrival and development of new players and originations of several additional rounds for current existing PE/VC funds to raise money. We are certain that entrepreneurs and business angels will continue to have a great influence to further stimulate and help build PE/VC sector in Poland.

We trust that improvement and enhancement programs in regulatory framework, legal solutions and the tax improvements will further accelerate the growth of this very important economy's engine in Poland. We are certain that PE/VC will produce a strong growth to reach its dominant position in this part of the Central Europe.

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BARIERY ROZWOJU SEKTORA PE/VC W POLSCE

Streszczenie

W artykule autorzy zawarli swoje spostrzeżenia i wnioski wypływające z obserwacji rynku, zebranych materiałów oraz przeprowadzonych w roku 2007 wywiadów z wybranymi podmiotami należącymi do środowiska funduszy *private equity*/*venture capital* dotyczących najważniejszych barier spowalniających dynamikę rozwoju tego sektora w Polsce. Na podstawie istniejącego rozwiązania podjęto próbę uzupełnienia modelu środowiska sprzyjającego dalszemu rozwojowi tego typu funduszy w Polsce.